

REPORT OF EXAMINATION
OF THE
MERCED MUTUAL INSURANCE COMPANY
AS OF
DECEMBER 31, 2010

Filed October 19, 2011

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San Francisco, California
August 19, 2011

Honorable Dave Jones
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

MERCED MUTUAL INSURANCE COMPANY

(hereinafter also referred to as the Company) at its home office located at 971 East Broadway, Atwater, California 95301.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2006. This examination covers the period from January 1, 2007 through December 31, 2010. The examination was conducted in accordance with the National Association of Insurance Commissioners' Financial Condition Examiners' Handbook. The Handbook requires the planning and performance of the examination to evaluate the Company's financial condition, to identify prospective risks, and to obtain information about the Company, including corporate governance, identification and assessment of inherent risks, and the evaluation of the system controls and procedures used to mitigate those risks. The examination also included an assessment of the principles used and the significant estimates made by management, as well as an evaluation of the overall financial statement presentation, and management's compliance with Statutory Accounting Principles and Annual Statement instructions. All accounts and activities of the Company were considered in accordance with the risk-focused examination process.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further

comment: company history; fidelity bonds and other insurance; pensions, stock ownership and insurance plans; growth of company; loss experience; statutory deposits; and sales and advertising.

MANAGEMENT AND CONTROL

Management of the Company is vested in a six-member board of directors who are elected for three-year terms. As of December 31, 2010, the directors and principal officers were as follows:

Directors

Name and Residence

Principal Business Affiliation

James A. Abbate
Merced, California

Owner and Operator
McDonald's Restaurant Franchises

Michael M. Brem
Turlock, California

President
SupHerb Farms

Michael E. Gemperle
Turlock, California

Partner
Gemperle Farms

Michael D. Kobane ^(a)
Turlock, California

President and Chief Executive Officer
Merced Mutual Insurance Company

Garth A. Pecchenino
Merced, California

Partner
Fremming, Parson & Pecchenino Consulting
Engineers

Thomas K. Sperry
Turlock, California

Owner and Operator
Boies Medical Center Pharmacy

Principal Officers

<u>Name</u>	<u>Title</u>
Michael D. Kobane ^(a)	President and Chief Executive Officer
Mary B. Shambaugh	Corporate Secretary
Thomas K. Sperry	Treasurer
Donald R. Duran ^(a)	Executive Vice President

The following changes in management occurred subsequent to the examination date:

^(a) Effective June 2, 2011, Michael D. Kobane retired as President, Chief Executive Officer (CEO) and Director. Donald R. Duran was appointed by the Board of Directors to take his place as President, CEO and was elected to the Board of Directors.

COPORATE RECORDS

The Company amended its bylaws on November 13, 2007, but did not file the amendment with the California Department of Insurance pursuant to the Annual Information Statement. The Company submitted the amended bylaws on August 8, 2011.

TERRITORY AND PLAN OF OPERATION

The Company was admitted to do business as a general mutual insurer on May 14, 1982. It was a county mutual fire insurer prior to that date, and has been operating in California since 1906. The Company is authorized to write fire, surety, plate glass, liability, burglary, and miscellaneous lines of business. The Company is only licensed in California and has no pending applications for admission into other states.

Effective January 1, 2010, the Company ceased renewing its Farmowners line of business. The Company experienced a substantial decline in Farmowners business and determined that it was not economically feasible to continue writing that coverage line. By year-end 2010, the

Company successfully converted roughly 25% of its Farmowners policies into Homeowners policies contingent on there being no active farming on that property.

During the examination period, the majority of the business was written in Northern and Central California. The major lines of business were homeowners' multiple peril, fire, and other liability - occurrence which accounted for 85.4%, 7.9%, and 2.5%, respectively, of the \$4.7 million in total direct premiums written in 2010.

Business is produced through approximately 102 independent agents.

REINSURANCE

Assumed

During the examination period, the Company assumed immaterial amounts of reinsurance from California Mutual Insurance Company, NAMIC Insurance Company, Inc., and a Regional Reciprocal Catastrophe Pool.

It is noted that the Net Quota Share Reinsurance agreement with California Mutual Insurance Company, effective January 1, 2010, does not include an entire agreement provision as required by California Code of Regulations (CCR), Title 10, Chapter 5, Article 3, Section 2303.13.(b). It is recommended that the Company revise the Net Quota Share Reinsurance Agreement with California Mutual Insurance Company to comply with CCR Section 2303.13.(b).

Ceded

The following is a summary of ceded reinsurance agreements in effect as of December 31, 2010:

<u>Type of Contract</u>	<u>Reinsurer's Name</u>	<u>Company's Retention</u>	<u>Reinsurers Maximum Limits</u>
First Excess of Loss	Munich Reinsurance America, Inc.	\$150,000 each risk in each occurrence	\$350,000 excess of \$150,000 on each risk in each occurrence,

<u>Type of Contract</u>	<u>Reinsurer's Name</u>	<u>Company's Retention</u>	<u>Reinsurers Maximum Limits</u>
			\$1,125,000 for all risks in any one occurrence
Second Excess of Loss	Munich Reinsurance America, Inc.	\$500,000 each risk in each occurrence	\$1,500,000 excess of \$500,000 on each risk in each occurrence, \$5 million for all risks in any one occurrence
Catastrophe First Layer	Munich Reinsurance America, Inc.	\$300,000 per occurrence plus 5% of \$700,000 in excess of \$300,000	95% of \$700,000 per occurrence in excess of \$300,000
Catastrophe Second Layer	Munich Reinsurance America, Inc.	\$1 million per occurrence plus 5% of \$1 million in excess of \$1 million	95% of \$1 million per occurrence in excess of \$1 million
Catastrophe Third Layer	Munich Reinsurance America, Inc.	\$2 million per occurrence plus 5% of \$2 million in excess of \$2 million	95% of \$3 million per occurrence in excess of \$2 million
Catastrophe Excess of Loss	Mutual Reinsurance Bureau	\$5 million any one loss occurrence	\$5 million in excess of \$5 million on any one loss occurrence, limited to \$10 million during the term of the agreement

ACCOUNTS AND RECORDS

Claims and Reserving Practices

The Claims Specialist from the California Department of Insurance noted that the Fair Claims Practices Regulations (FCRP) contained in the Company's claims manual are outdated and do not contain regulations added or expanded since 1997. This is a violation of California Code of Regulation (CCR), Title 10, Chapter 5, subchapter 7.5, Article 1, Section 2695.6.b.2.(a). It is recommended the Company revise the claims manual to include the latest FCRP to comply with CCR Section 2695.6.b.2.(a).

The Claims Specialist also noted that the depreciation tables contained in the claims manual base depreciation on age and useful life expectancy rather than age and condition as required by CCR

Title 10, Chapter 5, Subchapter 7.5, Article 1, Section 2695.9.(f). It is recommended that the Company revise its claims manual to include the appropriate depreciation table to comply with CCR Section 2695.9.(f).

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2010

Underwriting and Investment Exhibit for the year ended December 31, 2010

Reconciliation of Surplus as Regards Policyholders from December 31, 2006
through December 31, 2010

Statement of Financial Condition
as of December 31, 2010

<u>Assets</u>	<u>Ledger and Non-ledger Assets</u>	<u>Non- Admitted Assets</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 1,924,835	\$	\$ 1,924,835	
Stocks:				
Preferred stocks	545,531		545,531	(1)
Common stocks	11,088,825		11,088,825	
Real estate:				
Properties occupied by the company	138,954		138,954	
Cash and short-term investments	6,124,569		6,124,569	
Investment income due and accrued	18,198		18,198	
Uncollected premiums and agents' balances in the course of collection	203,779	328	203,451	
Reinsurance:				
Other amounts receivable under reinsurance contracts	98,244		98,244	
Current federal and foreign income tax recoverable and interest thereon	61,424		61,424	
Electronic data processing equipment and software	121,584	121,584		
Furniture and equipment	954	954		
Aggregate write-ins for other than invested assets	147,768		147,768	
Total assets	<u>\$ 20,474,695</u>	<u>\$ 122,866</u>	<u>\$ 20,351,829</u>	

Liabilities, Surplus and Other Funds

Losses		\$ 738,004	(2)
Loss adjustment expenses		600,027	(2)
Commissions payable, contingent commissions and other similar charges		173,661	
Other expenses		100,307	
Net deferred tax liability		1,232,569	
Unearned premiums		2,454,400	
Advanced premiums		81,797	
Amounts withheld or retained by company for accounts of others		17,747	
Total liabilities		5,398,512	
Unassigned funds	\$ 14,953,317		
Surplus as regards policyholders		14,953,317	
Total liabilities, surplus and other funds		<u>\$ 20,351,829</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2010

Statement of Income

Underwriting Income

Premiums earned		\$ 4,401,656
Deductions:		
Losses incurred	\$ 678,338	
Loss expenses incurred	861,852	
Other underwriting expenses incurred	<u>2,273,914</u>	
Total underwriting deductions		<u>3,814,104</u>
Net underwriting gain		587,552

Investment Income

Net investment income earned	\$ 32,029	
Net realized capital gains	<u>31,271</u>	
Net investment gain		63,300

Other Income

Net loss from agents' balances or premium balances charged off	\$ (3,828)	
Finance and service charges not included in premiums	<u>18,181</u>	
Total other income		<u>14,353</u>
Net income before federal income taxes		665,205
Federal income taxes incurred		<u>101,925</u>
Net income		<u>\$ 563,280</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2009		\$ 14,019,017
Net income	\$ 563,280	
Change in net unrealized capital gains	626,279	
Change in deferred income tax	(314,298)	
Change in nonadmitted assets	<u>59,030</u>	
Change in surplus as regards policyholders for the year		<u>934,300</u>
Surplus as regards policyholders, December 31, 2010		<u>\$ 14,953,317</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2006 through December 31, 2010

Surplus as regards policyholders, December 31, 2006, per Examination \$ 13,526,068

	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>
Net income	\$ 1,819,974	\$
Change in net unrealized capital loss		143,901
Change in net deferred income tax		202,702
Change in nonadmitted assets		<u>46,122</u>
Totals	<u>\$ 1,819,974</u>	<u>\$ 392,725</u>

Net increase in surplus as regards policyholders 1,427,249

Surplus as regards policyholders, December 31, 2010, per Examination \$ 14,953,317

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Preferred Stocks

The Company reported incorrect designations for several of its preferred stocks on Schedule D Part 2, Section 1 of the Annual Statement. It is recommended that the Company report the designations of its preferred stocks with those published by the National Association of Insurance Commissioners (NAIC) Securities Valuation Office in accordance with the NAIC Annual Statement Instructions.

(2) Losses and Loss Adjustment Expenses

Based on an analysis by a Casualty Actuary for the California Department of Insurance, the Company's loss and loss adjustment expense reserves as of December 31, 2010 were found to be reasonably stated and have been accepted for purposes of this examination.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Reinsurance - Assumed (Page 4): It is recommended that the Company revise the Net Quota Share Reinsurance Agreement with California Mutual Insurance Company to comply with California Code of Regulation (CCR), Title 10, Chapter 5, Article 3, Section 2303.13.(b).

Accounts and Records - Claims and Reserving Practices (Page 5): It is recommended that the Company update its claim manual to include the latest Fair Claims Practices Regulations to comply with CCR, Title 10, Chapter 5, subchapter 7.5, Article 1, Section 2695.6.b.2.(a). It is also recommended that the Company revise its claims manual to include the appropriate depreciation table to comply with CCR Section 2695.9.(f).

Comments on the Financial Statement Items - Preferred Stocks (Page 11): It is recommended that the Company report the designations of its preferred stocks with those published by the National Association of Insurance Commissioners (NAIC) Securities Valuation Office in accordance with the NAIC Annual Statement Instructions.

Prior Report of Examination

Comments on Financial Statement Items - Losses and Loss Adjustment Expenses (Page 9): It was recommended that the Company maintain documentation to support its Adjusting and Other reserves in accordance with the National Association of Insurance Commissioners (NAIC) Annual Statement Instructions. It was also recommended that the Company comply with California Insurance Code (CIC) Section 11558 in all future financial statements. The Company is now in compliance.

Comments on Financial Statement Items - Taxes, Licenses, and Fees and Current Federal Income and Foreign Income Taxes (Page 9): It was recommended that the Company properly report federal income taxes and taxes, licenses, and fees in accordance with NAIC Annual Statement Instructions. The Company is now in compliance.

ACKNOWLEDGMENT

Acknowledgment is made of the cooperation and assistance extended by the Company's officers and employees during the course of this examination.

Respectfully submitted,

/s/

Donavan Han, AFE
Examiner-In-Charge
Associate Insurance Examiner
Department of Insurance
State of California